Internal Revenue Service

memorandum

CC:TL-N-9113-91
FS:FI&P:CTSanderson

date: OCT 22 1991

to: District Counsel, Houston CC:HOU
Attn: Steve Diamond

from: Assistant Chief Counsel (Field Service) CC:FS

subject: [redacted] v. Commissioner, Docket No. [redacted]

This memorandum responds to yours of July 31, 1991. Pursuant to our instructions you asked for our assistance with the issue set out below. This case is presently calendared for the week of [redacted].[1]

ISSUE

Whether petitioner's cotton futures transactions were hedging transactions entitling the petitioner to treat the losses therefrom as ordinary losses. Issue No. 1221.00-00

CONCLUSION

Based on the present record, the petitioner has totally failed to show that he executed the futures transactions for the purpose of hedging as opposed to speculating. Consequently, there should be no reason for the court to have to address the impact of Arkansas Best Corp. v. Commissioner, 485 U.S. 212 (1988), on the character of hedging transactions. However, if the case is not settled and a trial is held, we will need to review the record developed at trial, including transcripts, in order to make a final determination whether the Arkansas Best/hedging issue needs to be addressed on brief. Accordingly, a reasonably generous briefing schedule should be requested.

[1] Recently, the petitioner's counsel has not been responding to your repeated messages concerning additional stipulations of facts. This may indicate that the petitioner will be unprepared for trial the week of [redacted], and a settlement or concession is likely.

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FACTS

The following facts were taken from the stipulation of facts and exhibits filed on [redacted]; from the respondent's and petitioner's trial memoranda filed on [redacted], and [redacted], respectively; and from telephone conversations between Steve Diamond of your office and Ted Sanderson of our office.

From [redacted] to [redacted], the petitioner was employed by [redacted], [redacted], Texas. During that period the petitioner worked as a cotton buyer on commission and purchased cotton in various parts of Texas. The petitioner had no employees or independent contractors employed by him at that time. At the end of [redacted], the petitioner was the head buyer for [redacted] and at that time did both the buying and recapping of the cotton for sorting into grades.

From [redacted] to the spring of [redacted], the petitioner was engaged in the cotton business doing business as [redacted], an unincorporated, sole proprietorship. The petitioner conducted his business of buying and selling cotton in [redacted] towns in [redacted] Texas. As [redacted] the petitioner employed one person as an office manager, secretary, and shipper and another person as a buyer, who worked at various locations.

During [redacted], the petitioner obtained [redacted] bales of cotton from [redacted] of the [redacted]. The petitioner sold this cotton to [redacted] for $[redacted] on [redacted]. (The petitioner did not report anything from this transaction on his [redacted] return; another issue in the case is whether he should have.) The petitioner purported to pay [redacted] for the cotton with a check for $[redacted] dated [redacted], but the check was returned marked "insufficient funds."[2]

On [redacted], a Texas state court entered a judgment against the petitioner finding, among other things, that the petitioner had fraudulently misrepresented to [redacted] that petitioner's check of $[redacted] for cotton purchased from [redacted] would be honored on [redacted], when the check was presented to the bank. The court further found that petitioner had fraudulently misrepresented to [redacted] that, when the

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[2] It is not clear from the present record exactly when the petitioner actually obtained the cotton from [redacted] other than sometime between [redacted] and [redacted], when he sold the cotton to [redacted]; nor is it clear when the petitioner gave his check to [redacted].

petitioner sold the cotton he obtained from [redacted], petitioner would apply all of the monies received from such sale to the payment of the $[redacted] "indebtedness" to [redacted]. The petitioner has offered no evidence that he owned any cotton during [redacted], or that he intended to buy any cotton during [redacted], other than the [redacted] bales obtained from [redacted] sometime between [redacted] and [redacted], and sold to [redacted] on [redacted].

On [redacted], the petitioner, in the name of [redacted], opened a nondiscretionary commodity trading account with [redacted] in [redacted], Texas. The petitioner had not been a prior customer of [redacted].[3] During the four-month period from [redacted] to [redacted], the petitioner traded over [redacted] long and short futures contracts in cotton. (The petitioner also did some futures trading in [redacted] after he opened the account with [redacted].)

On [redacted], [redacted] closed petitioner's open positions after a $[redacted] check that petitioner wrote to [redacted] to meet a margin call was returned unpaid due to insufficient funds. The petitioner's open positions at that time consisted of both long and short futures contracts in cotton. Litigation between the petitioner and [redacted] resulted from these events.

On his [redacted] return, petitioner claimed a business loss of $[redacted]. (The only income reported on the return was $[redacted] of wages.) An attachment to the return identified as a Schedule C listed $[redacted] of hedging losses as an expense. The hedging losses were attributable to commodity futures transactions executed through [redacted]. These losses plus other expenses on the Schedule C resulted in the $[redacted] loss reported on the return. Significantly,

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[3] The petitioner's new account documentation contains some pro forma information concerning petitioner's "potential hedging needs." However, petitioner apparently does not intend to offer any testimony other than his own that the trading in the account was done for hedging purposes. Compare Michelson v. Commissioner, T.C. Memo. 1990-27, 122 n.2, 130 (whether commodity account was designated a "hedging account" by broker is not determinative of tax issues; court disregarded petitioner's expert's testimony that account was a hedging account when expert relied almost entirely upon his belief that [redacted] had determined that the account was a hedging account).

however, the Schedule C listed gross receipts, beginning inventory, and ending inventory from business operations for [redacted] as 0.[4]

In his trial memorandum, the petitioner contends that he had a commodity trading account with [redacted] for the purpose of insuring himself a source of supply of cotton. He further contends that beginning in [redacted] he established a long position in the market to take possession of late spring and summer cotton. In the spring of [redacted], according to the petitioner, the market went against him and he experienced a margin call that he was unable to meet and which caused him to cease all operations as a cotton merchant.

By notice dated May 21, 1991, the National Office requested that field attorneys inform us of cases that involve Arkansas Best issues. In response to such notice, you apprised us of the present case. In an informal tax litigation advice dated July 1, 1991, we requested that you submit this case to us in a formal tax litigation advice request. Our concern in this area has been with the way the Service's position on the impact of Arkansas Best on the character of hedging transactions should be stated on brief. As explained more fully below, based on the present record, it appears that the impact of Arkansas Best on the character of hedging transactions need not be addressed in this case since the petitioner has totally failed to show that the transactions at issue were indeed hedging transactions as opposed to speculative transactions. However, if this case is not settled and a trial is required, we would like to review the trial record, including transcripts, as soon as possible in order to determine whether a discussion of the Arkansas Best/hedging issue is needed on brief. In light of our need to review the record, we request that you ask for a reasonably generous briefing schedule.

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[4] We suggest you look at the [redacted] return, if possible, to see if the petitioner reported any gross receipts or beginning inventory. The lack of gross receipts and inventory for [redacted] and [redacted] could be used to argue that petitioner was not a merchant or dealer in cotton who carried an inventory of cotton with respect to which there was a need to hedge. See Muldrow v. Commissioner, 38 T.C. 907 (1962); Michelson v. Commissioner, supra.

DISCUSSION

The petitioner relies on the section 1221(1) inventory exception to capital asset treatment as the basis for claiming an ordinary loss regarding the commodity futures contracts.[5] Citing Corn Products Refining Co. v. Commissioner, 350 U.S. 46 (1955), and Arkansas Best, supra, the petitioner contends that the futures contracts were a source of cotton supply and thus an integrally related part of the petitioner's cotton business. Presumably, the petitioner may also contend that the futures contracts were a hedge against price fluctuations with respect to physical cotton that he owned. Based on your and the agent's analysis of the futures transactions at issue, you have concluded that the transactions are totally inconsistent with any hedging strategy.

A threshold issue in any case concerning the character of alleged hedging transactions is whether the transactions were indeed bona fide hedging transactions, or instead was the taxpayer merely speculating in the futures market. The petitioner of course has the burden of proof on such an issue. T.C. Rule 142(a). Only if the court finds that the futures transactions were bona fide hedging transactions would it be necessary for it to address the character of the transactions under Corn Products and Arkansas Best, since it is clear that speculative futures transactions are capital. See, e.g., Farroll v. Jarecki, 231 F.2d 281 (7th Cir. 1956); Vickers v. Commissioner, 80 T.C. 394 (1983); Three G. Trading Corp. v. Commissioner, T.C. Memo. 1988-131.

As to what is a bona fide hedging transaction for the purposes of this issue in this case, in Sicanoff Vegetable Oil v. Commissioner, 27 T.C. 1056 (1957), the court defined a hedge generally as a "form of price insurance; it is resorted to by businessmen to avoid the risk of changes in the market price of a commodity. The basic principle of hedging is the maintenance of an even or balanced market position." Sicanoff Vegetable Oil, supra at 1066. See also Heltzer v. Commissioner, T.C. Memo. 1991-404 (slip op. at 63-64) ("Futures trading has not

[5] Section 1221(1) provides an exception to capital asset treatment for "stock in trade of the taxpayer or other property of a kind which would properly be included in the inventory of the taxpayer if on hand at the close of the taxable year, or property held by the taxpayer primarily for sale to customers in the ordinary course of his trade or business."

been treated as a part of a taxpayer's trade of business absent a showing that the trading corresponded with risks in the taxpayer's business and thus was a hedge.")[6]

The court in Sicanoff Vegetable Oil further noted that, in determining whether a transaction is a hedge, "all surrounding facts and circumstances must be scrutinized, in order to ascertain whether a particular transaction was intended to be a hedge, or speculation. A demonstrable relation must be shown to exist between the futures transaction and the business risk claimed to be hedged." Sicanoff Vegetable Oil, supra at 1067 n.2 (emphasis in original). In Sicanoff Vegetable Oil, the court concluded that the petitioner failed to prove that any of the alleged hedging transactions were bona fide hedges, even though the evidence presented by the petitioner in that case was far more extensive than that so far offered by the present petitioner.

The case of Muldrow v. Commissioner, 38 T.C. 907 (1962), is particularly indicative of the unlikelihood that the petitioner could sustain his burden of proof on the threshold issue of whether the futures transactions were bona fide hedges, at least on the basis of the present record. In Muldrow, the petitioner owned and operated a cotton warehouse. His business consisted of receiving and storing cotton for which he issued negotiable warehouse receipts. In the course of Muldrow's operations, he also made purchases of cotton for others on a commission basis. The only cotton sold by Muldrow during the relevant year, 1955, as his own and for his own account was embezzled cotton.

During 1955 and in years prior thereto, Muldrow also engaged in buying and selling commodity futures contracts for his own account. Muldrow was a member of various exchanges and personally made all buy and sell decisions, although the actual orders were placed with brokers. Prior to the time any of the futures transactions were executed, Muldrow transmitted form letters to the various brokers certifying that all transactions in cotton futures in which he requested "exemption from the original margin requirements" would consist exclusively of hedges. Additionally, at the inception of certain futures transactions at issue, the transactions were designated by Muldrow, and in turn carried by each carrying futures broker, as hedging transactions. Muldrow had a net loss from the

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[6] This memorandum does not address what types of hedging transactions qualify for ordinary treatment after Arkansas Best. Suffice it to say that even under a general definition of hedging, as contained in Sicanoff Vegetable Oil, the petitioner has totally failed to prove that his futures transaction were hedging transactions and not speculative transactions.

futures transactions which he deducted as an ordinary loss.

On the question of whether the transactions were bona fide hedging transactions, the court said:

> The only evidence of record which even tends to show that petitioner's transactions in cotton futures were hedges is that petitioner, by form letters, had represented to brokers that the transactions in cotton futures in which he would request "exemption from the original margin requirements" covered by a designated rule of the exchange, would fall into one or more of the categories listed in the form letters as hedges; that in initiating the said transactions herein with the brokers he had designated them as hedging transactions and the carrying futures broker, in each instance, had carried the transactions as hedges on its books and records. There is no suggestion or claim that the brokers required any showing or made any determination that the transactions were in fact hedging transactions.[7]
>
> On the other hand, the facts which are shown relative to petitioner's operations and to the transactions themselves fail to disclose any basis or justification for designation of the futures transactions as hedges. Petitioner had no inventory of spot cotton at the beginning or close of the taxable year, and he made no purchase of spot cotton during the taxable year. He was not a producer or processor of cotton. He owned no cotton during the year and his only sales for his own account were the sales of 812 bales of embezzled cotton. It is true that he had bought, and presumably sold, some spot cotton in the 4 years preceding the taxable year. But there is no proof to show that his transactions in cotton futures even in prior years, to say nothing of such transactions in the taxable year, were in any respect hedges connected with his purchases of spot cotton. Such being the state of the record, we may not properly conclude that the transactions herein were in fact hedging transactions, rather than a speculative buying and selling futures by petitioner. (Id. at 914.)

The court went on to reject Muldrow's contention that if the futures were not "true" hedges, they were an integral part of his warehouse business and that the losses were ordinary under Corn Products. "Not only is there no showing that the

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[7] See footnote 3 supra concerning the evidentiary weight of the broker designating the account as a hedging account.

futures transactions were an integral part of or even related to petitioner's warehouse operations, but the facts which are of record tend to show that they were not." Id. at 914.

Similarly, the present petitioner apparently will offer no proof, other than his own self-serving testimony, to show that his futures transactions were in any respect hedges connected with his cotton business. See also Sicanoff Vegetable Oil Corporation v. Commissioner, supra, and Meade v. Commissioner, T. C. Memo. 1973-46, 211, where the court, after noting that with few exceptions "the relationships between the petitioner's business operations and his commodity market transactions were never shown," said: "It is petitioner's burden of proof . . . and without testimony or other evidence which would point out the true nature of the commodity transactions we are constrained to hold for the respondent."

Another case on point is Patton & Richardson, Inc. v. Commissioner, T.C. Memo. 1981-288. The petitioner in Patton & Richardson was a cotton merchant who bought and sold cotton on its own account and for others on commission. The petitioner also dealt with cotton futures. As in the present case, the issue in Patton & Richardson was whether losses on cotton futures were ordinary or capital. On a record that was significantly more favorable to the petitioner than the current record is to the present petitioner, the court in Patton & Richardson held that there was "no evidence to show that the petitioner bore any risks which were offset by its futures transactions;" instead, Patton & Richardson's "futures transactions constitiuted simple speculation." Id. at 988. See also Myers v. Commissioner, T.C. Memo. 1986-518 (cattle and grain farmer's futures in cattle and grain found to be speculative and not bona fide hedges); Patterson v. Commissioner, T.C. Memo. 1981-43 (soybean farmer's futures in soybeans found to be speculative and not bona fide hedges); Lewis v. Commissioner, T.C. Memo. 1980-334 (cattle feedlot owner's futures in cattle found to be speculative and not bona fide hedges); Hendrich v. Commissioner, T.C. Memo. 1980-322 (wheat farmer's futures in wheat and corn found to be speculative and not bona fide hedges).

Petitioner's Transactions:

Other than generalizations, the present petitioner has totally failed to explain how his futures transactions functioned to protect him against any business risk, or for that matter what risk he was attempting to protect against. Apparently, his futures positions consisted of both long and short positions. Holding short positions is inconsistent with the statement in petitioner's trial memorandum that the futures were intended to insure himself a source of supply of cotton. A short position provides the holder with the right to make

future delivery of the underlying commodity, not the right to take future possession as does a long position. See, generally, Vickers v. Commissioner, supra at 396; Sicanoff Vegetable Oil v. Commissioner, supra at 1067 n.2. To the extent the petitioner argues that the short positions were to protect him against fluctuations in the price of actual cotton that he owned, petition has not shown that he owned any cotton during [redacted] other than the [redacted] bales that he sold on [redacted].[8]

As to the petitioner's long positions and his assertion that he intended to take possession of late spring and summer cotton, actual delivery on futures contracts is rare. See Vickers v. Commissioner, supra at 398. Furthermore, the petitioner has offered no evidence to support his contention that he intended, or even had the capability, to actually take possession under the long futures contracts. See Lewis v. Commissioner, supra at 1506 (ability to take delivery and use in business is relevant).

Additionally, you state that a large number (over [redacted] in a [redacted] month period) of the petitioner's [redacted] trades were day trades wherein positions were taken and closed within a single day's trading session. The petitioner has offered no explanation of how day trading is consistent with his alleged hedging strategy. Similarly, the petitioner has not explained how trading such a large volume of futures contracts ([redacted] long and short positions from [redacted] to [redacted] is consistent with his alleged hedging strategy as opposed to being consistent with an attempt to profit from fluctuations in the price of the futures, i.e., speculating. See Myers v. Commissioner, supra; Lewis v. Commissioner, supra.

It also appears that some of the futures transactions at issue were part of straddle transactions. A straddle "does not ordinarily qualify as a bona fide hedge." Sicanoff Vegetable Oil v. Commissioner, supra at 1067. See also Smith v. Commissioner, 78 T.C. 350, 355 (1982) (discusses the mechanics of straddle transactions); Myers v. Commissioner, supra; Hendrich v. Commissioner, supra.

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[8] You should compare the time periods for the short positions with the period that the petitioner held the physical cotton and point out the discrepancies to the court, since holding a short futures position as a hedge against price fluctuations of a physical commodity does not make any sense if the petitioner was not simultaneously long the physical. See Patterson v. Commissioner, supra at 124; Hendrich v. Commissioner, supra at 1452.

Arkansas Best:

Since the petitioner has totally failed to show, at least on the present record, that the futures transactions were bona fide hedges, the court should not have to address the impact of Arkansas Best on the character of hedging transactions. It is well settled that unless a futures contract is a bona fide hedging transaction it is generally considered speculative and therefore capital. See, e.g., Farroll v. Jarecki, supra; Vickers v. Commissioner, supra; Three G. Trading Corp. v. Commissioner, supra. Therefore, a consideration of Arkansas Best is not needed.

On the lack of a need to address Arkansas Best, this case is somewhat similar to Michelson v. Commissioner, T.C. Memo. 1990-27. The issue in Michelson was the proper characterization of the net losses on commodity futures, principally silver futures, as ordinary or capital. As here, the proper characterization depended on whether the commodity futures were "capital assets" within the meaning of section 1221. Also as in the present case, the only exception to capital asset treatment on which Michelson could potentially rely was section 1221(1).

Michelson contended that he was a dealer in metals and that the commodity futures contracts were hedging transactions integral to his trade or business as a metals dealer, in an apparent attempt to invoke the presumed judicial exception of Corn Products to section 1221. The court, without addressing the impact of Arkansas Best on Corn Products, concluded that the record simply did not establish that Michelson had any trade or business separate and apart from his transactions on the commodity exchanges. Michelson, supra at 130.[9] In a footnote, the court stated that it "need not . . . address the question of whether the Corn Products doctrine retains any vitality after . . . Arkansas Best Corp. v. Commissioner . . . . Suffice it to say here, even before the Arkansas Best opinion and even assuming the full vitality of the Corn Products doctrine in its most expansive interpretation, petitioner could not prevail." Michelson, supra at 131 n.12.

The court reached a similar conclusion in Heggestad v. Commissioner, 91 T.C. 778 (1988), wherein the petitioner, relying on Corn Products, contended that his Treasury bill futures transactions were an integral part of his partnership's

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[9] On whether the present petitioner was in the trade or business of buying or selling cotton during [redacted] as he alleges, it is interesting that the Schedule Cs in the returns for [redacted], [redacted], and [redacted] all reflect gross receipts, beginning inventory, and ending inventory as being 0. See footnote 4 supra.

commodities brokerage business. The court said: "We need not, however, attempt to resolve the present scope of the Corn Products doctrine in light of the Arkansas Best . . . case. Petitioners bear the burden of proof . . . . Even under the prior existing caselaw petitioners, on this record, have not established that they are entitled to ordinary loss treatment." Heggestad, supra at 787. We think that on the existing record in the present case the court should also conclude that it is not necessary to address the impact of Arkansas Best on the character of hedging transactions since the petitioner has totally failed to prove that his futures transactions were bona fide hedges.

Conclusion:

Based on the present record, the petitioner has totally failed to show that he executed the futures transactions for the purpose of hedging as opposed to speculating. Consequently, there should be no reason for the court to have to address the impact of Arkansas Best on the character of hedging transactions. However, if the case is not settled and a trial is held, we will need to promptly review the record developed at trial, including transcripts, in order to make a final determination whether the Arkansas Best/hedging issue needs to be addressed on brief. Accordingly, a reasonably generous briefing schedule should be requested.

Please keep Mr. Sanderson (FTS 566-3345) apprised of the status of this case, and contact him if you have any questions.

DANIEL J. WILES

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